BANK SHOTS

BY LORI PIZZANI

U.S. and global banks face "one of the most challenging operating environments in history"

Most of the large U.S. and global banks have been in defensive mode for months now, planning head-count reductions in the hundreds or thousands, scaling back employee and executive bonuses and in some cases salaries, and deciding which business units will stay and which will be shuttered. New U.S. regulations, reserve requirements, slowing growth, and downgrades by rating agencies (themselves under intense scrutiny) have caused bank executives to rethink their businesses going forward.

Will draconian measures to get banks lean and mean really help? Can axing employees alleviate banks' afflictions?

"Not enough," says Rodrigo Quintanilla, managing director and head of research for North American financial institutions at Standard & Poor's in New York City. "The problem is when banks are so troubled they start cutting into muscle, not fat," he adds.

S&P projects that 2012 will be a challenging year for U.S. banks in particular. The pessimistic outlook depends largely on continuing concerns about Europe's sovereign debt crisis affecting the U.S.—combined with a fragile U.S. economic environment, slowing trade flows, continued debt reduction by corporations and households, and an environment of extremely low interest rates. U.S. Federal Reserve Chairman Ben Bernanke has promised to keep interest rates at record lows until at least the end of 2014. Adding to banks' woes are new regulations. Heavier supervision and enforcement and increased compliance will all add to banks' costs. Overall, S&P predicts reduced profitability for U.S. banks through 2013 because revenue growth will be difficult to achieve.

"Unlike other credit cycles [of the past], this is particularly difficult because of the housing problem, plus a drag for regulatory burdens and macro problems," Quintanilla says. "There is evidence that things won't get better anytime soon; we are not optimistic." He adds that most banks will have to operate under a new business model, and banks will have to rethink which businesses are in and which are out.

"With incredibly fragile lending conditions and widespread regulatory overhang, global banking conglomerates are facing one of the most challenging operating environments in history," says Bill Hazelton, founder and executive editor of consumer advocacy site creditcardassist.com. With respect to the U.S., he adds, it's harder than ever for banks to make money underwriting home loans: "Lending criteria in the U.S. are incredibly strict, and interest rates are at generational lows. The big banks are finding it next to impossible to scale home loan profitability right now."

Consequently, banks are reassessing their strengths and weaknesses and determining what businesses will improve profit margins long term. "In the face of these challenges, many of the largest international players have been forced to return to their core strengths in global, corporate, and transactional banking, such as credit cards," Hazelton adds.

New regulatory mandates under Basel III banking rules will also challenge banks as compliance costs add to the equation.

Approved in September 2010 by the Basel Committee on Banking Supervision of the Bank for International Settlements, the new standards and requirements will be phased in through 2019 and are aimed at improving the resiliency and safety of the global banking system. Among other

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requirements, which include new processes and reporting, banks will have to increase their capital reserve amounts.

"Basel III is more than just another set of checks and balances for financial institutions in a post-crisis world," explains a November 2010 report from McKinsey & Company, the global management consulting firm. "It represents the core component of a sweeping wave of regulation that will fundamentally affect the profit-generation capacity of the banking industry." By improving the quality and depth of banks' capital and liquidity management, the goal is to spur banks to improve their underlying risk management.

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Technically Insolvent?

"Over the last 30 to 40 years, this country's growth has come from financial leverage (hitting a peak in 2006–07) and not productivity," says Michael Lebowitz, CFA, the founder and principal of Absolute Investment Management of Bethesda, Maryland (a company that does not invest in banks). "We really got good at creating ways to creatively borrow, but now we're in a long cycle of deleveraging."

Lebowitz believes that U.S. banks are technically insolvent. The 2008 change in accounting rules allows banks to price certain assets at cost rather than at current (and likely much deflated) values. Thus, current losses are not being calculated correctly. The rule change, which was made under pressure from both banks and Congress, allows banks to ignore real values of assets. "Recognizing the true value of assets would have instantly wiped out many banks here and abroad," he says. As a result, an accurate valuation of a bank can be impossible—"We do not invest in or own banks, nor do we short banks. I don't know what they're worth."

Moreover, because many provisions under the U.S. Dodd–Frank legislation are still being hashed out and certain regulations have yet to be written, those sweeping reforms have actually done little to fix many of the core problems. "It doesn't address too big to fail," says Lebowitz, citing an example of one defect that hasn't been adequately addressed by Dodd–Frank.

"Banks in general—their margins and their revenues—are in jeopardy. Capital markets are seeing declining IPOs, so I don't see capital markets pushing earnings higher," he adds. "Europe is worse—banks are bigger as a percentage of their economies, with potentially weaker regulations."

Deep Structural Problems

"Europe is feeling the effects of vast private-sector balance-sheet problems, tightening fiscal policy, a banking system that depends on (European Central Bank [ECB]) life support, and an ongoing credit crunch," contends a 17 February 2012 report from the Jerome Levy Forecasting Center in Mount Kisco, New York. "The eurozone's problems are deep, its structure still inadequate, its policies problematic, and the challenges ahead still enormous," the report continues.

As a percentage of GDP, these banks account for two-and-a-half to three times that of the U.S., and in the U.K. or Switzerland, it's more like six or seven times, according to Srinivas Thiruvadanthai, CFA, managing director and director of research at the Jerome Levy Forecasting Center. In the current environment, if the government had to rescue a European bank, it would swamp that government's already over-burdened resources. Thiruvadanthai calculates that a rescue comparable to the US$700 billion financial bailout in the U.S. would need to be three times that amount in Europe.

Although most observers see the eurozone's challenges as being a banking industry and/or a sovereign debt problem, there is another—even greater—challenge. "The level of non-financial private debt in Europe is bigger than in the U.S., on top of the bank financing and sovereign debt problem," he says. The picture is "so much more unstable," he adds.

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The situation in the eurozone goes beyond too much debt. There is also too little growth. That nasty combination has shown up in both the public and private sectors, with banks facing compressed deposit margins, lower growth rates, and low interest rates. "Banks' balance sheets are shrinking, so fixed costs and debt expenses are spread over lower assets," says John Nadell, CFA, managing director and analyst with the global equity team at Neuberger Berman in New York City. "And with low returns, it is hard to absorb any unexpected surprises or negative news."

Many banks have been focused on cutting employee headcount and deleveraging by selling off units, as was the case with the recently announced sale of BNP Paribas' North American US$9.5 billion energy lending business to U.S.-based Wells Fargo Bank. (Terms of the sale were not disclosed.) Going forward, global banks won't have to sell off businesses at fire-sale prices. "Now they can sell a bit more deliberately," says Nadell, who expects that there will be pressure for larger global banks to take over weaker banks, as has been happening in Spain recently. "Regulators will strongly encourage this," he says.

European banks may be down, but they are not necessarily out.

"The European banking sector still faces massive challenges, including capital-raising issues," says David Leduc, CFA, chief investment officer of active fixed-income strategies at Standish Mellon Asset Management, headquartered in Boston. Many of the same issues that the U.S. banking sector dealt with beginning in late 2008 are now haunting the European banking sector. But don't expect to see the multitude of challenges force any of the big banks (including Barclays, Credit Suisse, Lloyds, Société Générale, Santander, and others) into bankruptcy. "There are large financial institutions in Europe that will survive this," notes Leduc.

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Desperately Seeking Solutions

Banks are in the initial phase of a long process, but shorter-term, more immediate needs must still be addressed.

In December 2011, the ECB established the Long-Term Refinancing Operation (LTRO), which allowed only banks within the 17-country eurozone to raise funds for a three-year period. The ECB offered a second round of refinancing in late February 2012. This offering was intended to ease the burden of cash-strapped European banks that lacked the money to pay their maturing debt because long-term funding had all but dried up. The initiative was executed to prevent a full-blown banking crisis.

The need for the operation highlights a critical difference between the U.S. and Europe. "In Europe, banks won't lend to each other, which is why you have an LTRO," Leduc says. But simply establishing the facility won't necessarily suffice. Leduc likened the situation to that of an accident victim (the European banks) who has broken bones and needs surgery. The victim has now been placed onto a gurney, but not much will be solved until the actual operation to repair the broken bones is performed.

"In Spain, for example, many of the banks have not been aggressive enough in writing down their assets. Many are still sitting on assets with questionable valuations," Leduc says.

"Spanish regulations can allow banks to write down what they can get away with without too much pain," echoes Tineke Frikkee, CFA, lead manager for equity income strategy at London-based Newton Investment Management. But more needs to be done. "We are cautious on banks," she adds. "We think there are still big issues to be resolved."

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